

Private Letter Ruling: REIT dividends are dividends within the meaning of IITA Section 304(c)(1)(C), and income from REIT dividends included in federal taxable income in years other than the year of receipt pursuant to a change in accounting procedure is also treated as dividend income under of IITA Section 304(c)(1)(C).

April 14, 2003

Dear:

This is in response to your letter dated February 6, 2003, in which you request a Private Letter Ruling (PLR) on behalf of COMPANY1. Review of your request disclosed that all information described in paragraphs 1 through 8 of subsection (b) of 2 Ill. Adm. Code 1200.110 has been provided. This PLR will bind the Department only with respect to COMPANY1 for the issues presented in this ruling. Issuance of this ruling is conditioned upon the understanding that COMPANY1 and/or any related taxpayer is not currently under audit or involved in litigation concerning the issues that are the subject of this ruling request.

The facts and analysis as you have presented them are as follows (footnotes omitted):

On behalf of our client, COMPANY1 ("Taxpayer"), we respectfully request the Illinois Department of Revenue ("the Department") to issue a private letter ruling pursuant to 2 Ill. Adm. Code Section 1200.110 with respect to the following factual situation.

General Information

1. Enclosed please find an original Form IL-2848 Power of Attorney, authorizing COMPANY2 to represent Taxpayer before the Department of Revenue.
2. This PLR is not requested with regard to hypothetical or alternative proposed transactions. The PLR is requested to determine the income tax consequences of the actual business practices of Taxpayer.
3. Taxpayer is not currently engaged in litigation with the Department in regard to this or any other tax matter.
4. The Department has not previously ruled regarding this matter for Taxpayer. Neither Taxpayer nor COMPANY2 has submitted the same or similar issues to the Department.
5. Taxpayer requests that certain information be deleted from the PLR prior to dissemination to others. Taxpayer requests that its name, address, location of its headquarters, description of products being purchased and the name of its representative be deleted.
6. Taxpayer knows of no authority contrary to the authorities referred to and cited below.

Statement of Material Facts

Taxpayer, a limited liability company organized in the state of STATE, is commercially domiciled in CITY, Illinois. Taxpayer is a wholly owned first tier operating subsidiary of Bank ("Bank"). Bank is a wholly owned Bank subsidiary of COMPANY3. COMPANY3, a corporation

organized in the state of STATE, is the common parent of a group of corporations that files a consolidated federal income tax return.

Taxpayer owns all of the common membership interests of REIT, a real estate investment trust as defined by Internal Revenue Code ("IRC") Section 856. Both Taxpayer and REIT are manager-managed LLCs that elect to be treated as corporations for federal income tax purposes. REIT files a separate federal corporate income tax return.

As required under federal tax law, each year REIT distributes greater than 90% of its taxable income in the form of dividends paid to its shareholders. All dividends paid by REIT to Taxpayer are "received" by Taxpayer in FOREIGN COUNTRY. Other than interest income from cash balances and investments, which represent only a small percentage of Taxpayer's income, REIT dividends are Taxpayer's only source of income.

Bank, Taxpayer, and REIT are financial organizations as defined in Section 1501(a)(8) of the Illinois Income Tax Act ("IITA"). Taxpayer has historically filed a separate return in Illinois because of the statutory prohibition against including within the unitary business group entities that conduct more than 80 percent of their business activities outside the United States. REIT carries on unitary business activities with Bank and is included in an Illinois combined return with Bank.

COMPANY3, Bank, and REIT have calendar tax years that end on December 31.

Pursuant to an election made with the filing of the consolidated federal income tax return for tax year 2000, Taxpayer changed its taxable year to a 52-53 week. Taxpayer changed to an annual period which ends on the last Sunday in December. Taxpayer keeps a reconciliation to its 52-53 week annual tax period results from the calendar year basis upon which it keeps its books for GAAP purposes.

Taxpayer's tax year for 2002 ends on December 29, 2002. REIT will declare a substantial portion of its annual dividends on December 30, 2002. REIT will distribute such dividends to Taxpayer in January of 2003 ("the 2002 Spillover Dividend"). The 2002 Spillover Dividend paid by REIT in January of 2003 will be "received" by Taxpayer in FOREIGN COUNTRY. Although actually paid in January of 2003, under IRC Section 857(b)(9), the 2002 Spillover Dividend is deemed to be received by Taxpayer on December 31, 2002, for federal tax purposes.

REIT qualifies as a pass-through entity for purposes of IRC Section 6655(e)(5)(B) and Treasury Regulation Section 1.441-2(e).

In accordance with Treasury Regulation Section 1.441-2(e), for purposes of determining the taxable year in which items of income, gain, loss, deduction, or credits from REIT are taken into account by Taxpayer, Taxpayer's taxable year will be deemed to end on the last day of the REIT's taxable year (December 31st).

Taxpayer will include REIT dividends in income ratably over the four-taxable-year period beginning with tax year 2002, pursuant to the transition rule provided under Treasury Regulation Section 1.441-2(e)(5).

For federal tax purposes, under the transition rule provided by Treasury Regulation Section 1.441-2(e)(5), 25 percent of the 2002 Spillover Dividend will be recognized by taxpayer in its 2002 tax year deemed ending on December 31, 2002, 25 percent will be recognized in Taxpayer's 2003 tax year deemed ending on December 31, 2003, 25 percent in Taxpayer's 2004 tax year deemed ending on December 31, 2004, and the final 25 percent in Taxpayer's 2005 tax year deemed ending on December 31, 2005.

Rulings requested

Taxpayer respectfully requests a binding PLR from the Department confirming that:

1. Illinois conforms to the deemed federal year end as required under Treasury Regulation Section 1.441-2(e).
2. Taxpayer's receipt of REIT dividend income as "dividends" for Illinois income tax purposes is not impacted by Treasury Regulation Section 1.441-2(e).
3. The sourcing of dividends for apportionment and corresponding 80/20 company testing purposes will be based upon where "received" regardless of the changes to inclusion of taxable income over multiple periods as provided under Treasury Regulation Section 1.441-2(e)(5).

Relevant Authorities and Discussion

1. Accounting Period and Income Recognition

On May 16, 2002, Treasury Regulation Section 1.441-2 was issued concerning the use of 52-53 week tax years and is effective for tax years ending on or after May 17, 2002. Pursuant to Treasury Regulation Section 1.441-2(e):

If a pass-through entity ... or an owner of a pass-through entity, or both, use a 52-53 week taxable year, and the taxable year of the pass-through entity ... and the owner end with reference to the same calendar month, then, for purposes of determining the taxable year in which items of income, gain, loss, deductions, or credits from the pass-through entity are taken into account by the owner of the pass-through, the owner's taxable year will be deemed to end on the last day of the pass-through's taxable year.

For purposes of Treasury Regulation Section 1.441-2(e), a pass-through entity includes a closely-held REIT within the meaning of IRC Section 6655(e)(5)(B). The changes required by Treasury Regulation Section 1.441-2(e) affect the period in which items of income, gain, loss, deductions, or credits from the pass-through entity are taken into account. For this purpose, the 52-53 week owner of the pass-through entity is "deemed" to have the same tax year end as the pass-through.

In general, Illinois adopts the federal accounting period and any subsequent federal changes to that period. Section 403(a) of the IITA requires that taxpayers follow the federal income tax treatment of all items on the Illinois income tax return. Specifically, Section 403(a) of the IITA provides:

(a) Reporting –

To the extent not inconsistent with the provisions of this Act or forms or regulations prescribed by the Department, each person making a return under this Act shall take into account the items of income, deduction and exclusion on such return in the same manner and amounts as reflected in such person's federal income tax return for the same taxable year.

Treasury Regulation Section 1.441-2(e) results in a "deemed" change for purposes of determining the taxable year in which items of income, gain, loss, deductions, or credits from the pass-through entity are taken into account by the owner of the pass-through. Illinois IITA Section 403(a) requires taxpayers to "take into account the items of income, deduction, and exclusion on such return in the same manner and amounts as reflected in such person's federal income tax return for the same taxable year." Thus, to the extent that Treasury Regulation Section 1.441-2(e) is "deemed" to change Taxpayer's taxable year-end for purposes of taking into account (i.e. recognizing) REIT dividend income, the deemed federal change should be followed for Illinois income tax purposes.

Please confirm the foregoing.

2. Classification of Dividend Income

Treasury Regulation Section 1.441-2(e)(5) sets forth a transition rule relating to owners of pass-through entities that have adopted 52-53 week taxable years. Treasury Regulation Section 1.441-2(e)(5) provides:

In the case of an owner of a pass-through entity ... that is required by this paragraph (e) to include in income for its first tax year ending on or after May 17, 2002, amounts attributable to two taxable years of a pass-through entity, the amount that otherwise would be required to be included in income for such first taxable year by reason of paragraph (e) should be included in income ratably over the four-taxable year period beginning with such first taxable year under principles similar to [Treasury Regulation] § 1.702-3T, unless the owner of the pass-through entity elects to include all such income in its first taxable year ending on or after May 17, 2002.

Treasury Regulation Section 1.441-2(e)(5) specifically refers to Treasury Regulation 1.702-3T. Treasury Regulation Section 1.702-3T(b) states:

(b) Partner's treatment of items from the partnership's year of change –(1) In general. Except as provided in paragraph (c) of this section, if a partner's share of "income items" exceeds the partner's share of "expense items," the partner's share of each and every income and expense item shall be taken into account ratably (*and retain its character*) over the partner's first 4 taxable years beginning with the partner's taxable year with or within which the partnership's year of change ends. (Emphasis added).

In applying the provisions of Treasury Regulation Section 1.441-2(e), the methodology set forth in Treasury Regulation Section 1.702-3T should be followed by the taxpayer for federal

income tax purposes. As indicated above, Treasury Regulation Section 1.702-3T(b) specifically states that “each and every” item of income and expense shall retain its character over the four-year taxable period. Consequently, dividend income that is taken into account ratably over the four year period as provided by Treasury Regulation Section 1.441-2(e)(5) retains its character as dividend income for federal income tax purposes.

Illinois adopts the federal income tax classification and treatment regarding what constitutes a “dividend” for income taxation purposes. For financial organization apportionment purposes, the term dividend is defined as follows:

2) Dividend. “Dividend” means any item defined as a dividend under 26 USC 316 and any other item of income characterized or treated as a dividend under the Internal Revenue Code.

Thus, any item of income defined as a “dividend” for federal income tax purposes should also be considered a “dividend” for Illinois income tax purposes.

Based on the foregoing, if the provision set forth in Treasury Regulation Section 1.441-2(e)(5) does not alter the classification of REIT dividends as “dividends” for federal income tax purposes over the four-year period that they are taken into account pursuant to this regulation, then the adjustments required by the treasury regulation should not alter the classification of REIT dividends as “dividends” for Illinois income tax purposes during this four-year period.

Please confirm the foregoing.

3. Impact on Apportionment and the 80/20 Test

Illinois statutes provide that the Illinois unitary business group will not “include those members whose business activity outside the United States is 80 percent or more of any such member’s total business activity...”. In making this determination, the phrase United States includes only the fifty states and the District of Columbia.

Section 304(c)(1) of the IITA provides, in part, as follows:

In general. Business income of a financial organization shall be apportioned to this State by multiplying such income by a fraction, the numerator of which is its business income from sources within this State [United States for 80/20 test], and the denominator of which is its business income from all sources. For purposes of this subsection, the business income of a financial organization from sources within this State [United States for 80/20 test] is the sum of the amounts referred to in subparagraphs (A) through (E) following, ...

(C) Dividends, and interest from Illinois [United States for 80/20 test] customers, which are received within this State [United States for 80/20 test];

The Illinois Department of Revenue has ruled in the past that dividend income (qualifying as business income) received by a financial organization should be sourced and considered

outside the United States for purposes of the Illinois 80/20 test if such dividends are received in a foreign country.

In the present case, however, dividend income (the 2002 Spillover Dividend) is actually received both before and after the close of the taxable years in which it is deemed recognized for federal tax purposes. In this case, under the transition rule provided by Treasury Regulation Section 1.441-2(e)(5), 25 percent of the 2002 Spillover Dividend will be taken into account by Taxpayer in its 2002 tax year which is deemed to end on December 31, 2002. However, Taxpayer will not actually receive the 2002 Spillover Dividend until January of 2003. In subsequent tax years, 25 percent of the 2002 Spillover Dividend will be recognized in Taxpayer's 2003 tax year, 25 percent in Taxpayer's 2004 tax year, and the final 25 percent in Taxpayer's 2005 tax year. Illinois statutes and regulations are silent on the application of the apportionment and 80/20 testing rules in the situation where the timing of dividend income recognition and the receipt of same do not coincide.

Nevertheless, Illinois regulations do address an analogous situation in the context of sourcing interest income. Specifically, Illinois Admin. Regulation Section 100.3400(c)(3)(B) provides, in relevant part, as follows:

(B) Application –

...If payment of an item of interest income that has been accrued and included in base income for a tax year is not received prior to the date the return for that tax year is filed, the financial organization shall treat the payment as received at the location to which the borrower is directed to send payment or, if no single location is specified, at the location at which the financial organization reasonably expects to receive the interest....

Applying similar principles to the 2002 Spillover Dividend in this case yields the conclusion that Illinois will look to the location at which the 2002 Spillover Dividend is actually received for purposes of apportionment and 80/20 testing, notwithstanding the fact that recognition of the 2002 Spillover dividend is spread over four tax years, the first of which closes prior to the actual receipt of such dividend.

Please confirm the foregoing.

RULING

Under IITA Section 203(b)(1), the computation of a corporation's Illinois base income starts with its "taxable income for the taxable year." Section 203(e)(1) defines "taxable income" for this purpose as the amount of taxable income "properly reportable for federal income tax purposes for the taxable year under the provisions of the IRC. Consistent with these provisions, IITA Section 401(a) requires the taxpayer to adopt as its taxable year for Illinois income tax purposes its taxable year under the IRC. See also IITA Section 403(a).

Pursuant to these provisions, a taxpayer is required to take into account in computing Illinois net income for its taxable year, its items of gross income required to be taken into account in computing its federal taxable income for the same taxable year.

Accordingly, to the extent Taxpayer in this case properly takes into account for its federal taxable year ending December 29, 2002, dividends actually declared and paid in January of 2003, Taxpayer will take the same into account in computing Illinois net income the same taxable year. Likewise, to the extent taxpayer properly takes into account under the IRC dividends actually paid in January 2003 in subsequent taxable years, Taxpayer will take the same into account in computing Illinois net income in such subsequent taxable years.

IITA Section 102 states as follows:

Except as otherwise expressly provided or clearly appearing from the context, any term used in this Act shall have the same meaning as when used in a comparable context in the United States Internal Revenue Code of 1954 or any successor law or laws relating to federal income taxes and other provisions of the statutes of the United States relating to federal income taxes as such Code, laws and statutes are in effect for the taxable year.

Pursuant to this section, Illinois Department of Revenue Regulations ("Regulations") Section 100.3400(b)(2) states with respect to the apportionment factor of a financial organization that the term "dividend" means any item so characterized under the Internal Revenue Code. 86 Ill. Adm. Code 100.3400(b)(2).

In this case, then, to the extent Taxpayer's business income for the taxable year includes items properly characterized as "dividends" for purposes of the IRC, the same characterization applies in determining Taxpayer's apportionment factor under IITA Section 304(c).

Under IITA Section 304(c)(1), the business income of a financial organization is apportioned by multiplying such income by the fraction business income from sources in Illinois over total business income. Under Section 304(c)(1)(C), business income from sources in Illinois includes "[d]ividends ... which are received within this State." In determining whether a financial organization conducts more than 80% of its business activity outside the United States for purposes of IITA Section 1501(a)(27), Regulations Section 100.9700(c) requires the financial organization to apply the apportionment fraction prescribed under 304(c)(1), but comparing business income from sources within the United States to worldwide business income. For this purpose, business income from sources within the United States includes business dividends received within the United States. Regulations Section 100.9700(c)(2)(A) provides that the term "United States" refers only to the 50 states and District of Columbia.

In computing its apportionment fraction, a financial organization includes items of business income in the fraction for the same taxable year such income is taken into account in computing the financial organization's Illinois net income. See IITA Sections 304(c)(1) and 402(a).

Accordingly, Taxpayer in this case shall include REIT dividends in its apportionment fraction to the extent such dividends are included in Taxpayer's base income for the same taxable year, even if such dividends were actually received in a prior taxable year. For purposes of assigning such dividends to the numerator of the apportionment fraction, Taxpayer shall determine under Regulations Section

100.3400(c)(3)(B) the location at which such dividends are actually received where such receipt occurs prior to the due date of the return for the taxable year with respect to which such dividends are included in the apportionment formula. Thus, dividends Taxpayer actually receives in FOREIGN COUNTRY in January 2003 would not be included in the numerator of its Section 304(c)(1) apportionment formula for any taxable year, but would be included in the denominator of such formula for the same taxable year that such dividends are included in Taxpayer's base income.

The facts upon which this ruling is based are subject to review by the Department during the course of any audit, investigation or hearing and this ruling shall bind the Department only if the material facts as recited in this ruling are correct and complete. This ruling will cease to bind the Department if there is a pertinent change in statutory law, case law, rules or in the material facts recited in this ruling.

Sincerely,

Brian L. Stocker
Staff Attorney (Income Tax)